

The Down Side of Prize Winning

An Honors Thesis (HONRS 499)

By

Lesley Freeman

Thesis Advisor

Dr. John Ledbetter

A handwritten signature in black ink, appearing to read 'J. Ledbetter', with a large, stylized initial 'J'.

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Abstract

While winning a prize can be an exciting time, many winners do not take the time to think about what kind of taxes they are going to owe on these prizes. I decided to research the tax laws that apply to prizes and relate these laws to cases that I found involving prize winning. I focused primarily on cases involving noncash prizes, because these winners did not win any money to pay the attached taxes with. Based on my research, I chose to advise future winners with recommendations that they should consider so that they are not caught off guard when the IRS knocks on their door.

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Introduction

Winning a prize is always an exciting event, at least at the time of the announcement. Prize winners are often shocked, however, when they find out some of the consequences that come along with such prizes, particularly the income taxes. Many winners do not think about these tax consequences (which they may or may not be able to afford) until after they have accepted the prizes. If people were to think about these consequences ahead of time and plan for the potential tax liability, they would be much better off. That is why it is important for people to be aware of what the tax laws are regarding prize winnings, as well as what can happen if you are not aware of or disregard these statutes.

Tax Laws affecting Prize Winnings

26 U.S.C § 74- Prizes and Awards

First, it is necessary to know how prizes and awards are treated under the current tax code in the United States. The general rule is that prizes and awards are included in gross income as “other income,” with an exception for certain prizes and awards transferred to charities and for certain employee achievement awards (I.R.C. Sec. 74 Prizes and Awards). This taxability includes, but is not limited to, “amounts received from radio and television giveaway shows, door prizes, and awards in contests of all types” (Treas. Reg. 1.74 Prizes and Awards).

The exception to this rule is that gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. In order to meet this exception, criteria must be met: The recipient must have been selected without any action on his/her part to

enter the contest or proceeding; the recipient is not required to render substantial future services as a condition to receiving the prize or award; and the prize or award is transferred by the payer to a governmental unit or recognized charitable organization.

The situation gets even more complex when a prize offering is an item or service, rather than cash. Winners of these noncash prizes are still expected to pay income taxes on these items, even though they did not receive any money with which to help them pay the tax. The taxable value of a prize or award that is not made in money, but instead consists of goods or services, is its fair market value (Treas. Reg. 1.74 Prizes and Awards). The cost of the prize is not determinative; rather the fair market value is the price for which the taxpayer can sell the goods to a willing buyer.

State Taxes

When contestants win a prize on a game show, they must not only pay federal income taxes on the value of the prize, but must also pay state income taxes. Winners must file a state tax return in the state in which they won the prize (usually California or New York). They then claim a credit on their home state return for the amount of state tax that they would have paid if the prize had been won in their home state. If a winner's home state has a lower tax rate than the state in which they won the prize, they will incur a loss for the difference in taxes, because their credit on their home state return will be less than the amount of tax they paid on the return for the prize-giving state (Grant, 2011).

Cases Involving Cash Prizes

Richard Hatch

Taxation of prize winnings has spurred many controversial cases, both of cash and noncash recipients. One of the most infamous cases regarding a cash prize winner is that of

the original Survivor winner, Richard Hatch. Hatch was imprisoned for failing to pay income taxes on his one million dollar survivor prize, among other things. According to his appellate case, Hatch filed a tax return for the year 2000 which falsely stated a negative income of \$41,087 and that he was owed a refund of \$4,483. This reported income was completely false, given that he failed to report the one million dollars that he won on Survivor, the \$18,708 in rental income that he earned, and \$25,000 in charitable donations diverted to his own use. Hatch did not merely forget to include this income, but he intentionally excluded it, despite the arguments of his tax advisor. In 2006, Hatch was sentenced to 56 months in federal prison. This is arguably the longest sentence in U. S. history for someone owing the tax amount that prosecutors claimed Hatch owes (United States v. Richard Hatch, 2008).

Clarence W. Jones

Over the past decade, 73 year old Clarence Jones has cashed in more lottery tickets than any other person. He has cashed in over 10,000 winning tickets from the Massachusetts state lottery, totaling more than \$18 million in cash prizes. He has continually fought with state officials attempting to claim taxes on his winnings. Jones says that he is a professional gambler who spends millions of dollars in his attempts to win the lottery. These expenses, therefore, should offset his cash winnings. If he is, in fact, a professional gambler, it is true that he is able to offset his expenses and losses against his winnings.

Professional gamblers get a tax benefit because they are able to report their gambling winnings and their losses and expenses on Schedule C (for profit or loss from business), instead of reporting their winnings as ordinary income and their losses (to the

extent of their winnings) as itemized deductions. This gives them a tax benefit because a professional gambler can deduct any out-of-pocket expenses they incur, regardless of the amount they win. They do not have to include out-of-pocket expenses with their losses (whose deductibility is limited to their gains). Professional gamblers also benefit because reporting expenses as itemized deductions does not always help a tax payer if their standard deduction is greater than the total amount of their itemized deductions on Schedule A (Bischoff, 2012).

State officials, however, do not believe that Jones is actually a professional gambler. The state suspects that he is a professional ticket casher, who makes money cashing tickets for others so that they can avoid the taxes on the winnings. Such people are known as “10 percenters” because they take ten percent of the winnings in exchange for cashing in the lottery tickets. While it is not illegal to cash in another person’s winning ticket, it is illegal to do so in order to help them evade taxes or other legal obligations (Wallach, 2011).

Cases involving Noncash Prizes

Extreme Makeover: Home Edition

In regard to cases of noncash prize winnings, the television show *Extreme Makeover: Home Edition* has been highly scrutinized. One would think that the income tax on these extravagant homes would be outrageous, considering the homes have the appearance of a gift from the show’s producers to the families that are featured. The show, however, has found a way to avoid these taxes (for now at least) by using a loophole in the tax code. Section 280A(g) of the Internal Revenue Code provides an exception when the taxpayer rents a dwelling for less than fifteen days during the year.

Under Section 109, “gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee (I.R.C. Sec. 109 Improvements by Lessee on Lessor’s Property). The other side of this rule, however, is that the lessor is not able to increase the property’s basis on account of the improvements made by the lessee. Therefore, the taxation of the improvements is deferred until the lessor disposes of the property (I.R.C. Sec. 1019 Property on Which Lessee Has Made Improvements).

This creates deferred tax liability because when the family sells their residence in the future, they will pay tax on their gain, which is the difference in the selling price of the home and their adjusted basis in the property. Generally, when improvements are made to a residence, the owner’s adjusted basis increases to reflect the additional value added to the home(IRS Publication 523 Selling Your Home). Since families on Extreme Makeover: Home Edition are not able to increase their adjusted basis with the renovations that the show performs, they will end up with a huge gain if they decide to sell their residence in the future.

Fortunately for home owners, in order to counterbalance gains on the sale of a residence, there is an exclusion available. Single taxpayers are able to exclude \$250,000 of this gain and married taxpayers filing a joint return are able to exclude \$500,000 (IRS Publication 523 Selling Your Home). Therefore, taxpayers are only held responsible for paying taxes on gains from the sale of their residence if the gain exceeds \$250,000 for single taxpayers or \$500,000 for married taxpayers. While many of the families on

Extreme Makeover: Home Edition may experience such types of gains, the amount that they will have to pay taxes on is greatly reduced by this exclusion.

Before each episode, the show leases the families' homes for ten days and pays them \$50,000 worth of rent in appliances and furnishings, rather than in cash. Since the home is "rented" for less than fifteen days, the family is only taxed on the \$50,000 of rent and the rest of the renovations (or new structures) are considered nontaxable improvements to the property. So far, the IRS has not chosen to dispute the use of this loophole, despite the fact that it does not seem that the show is using it in the way in which it was originally intended (Nasner).

Certain states are choosing to address complications by enacting their own guidance. New Jersey, for example, has come up with its own regulation for families receiving renovations to their homes. New Jersey regulation permits short-term tax exemption or abatement for houses improved to accommodate disabled persons when reconstruction or renovation is performed by a charitable entity, or a for-profit organization using volunteer labor. In order for New Jersey citizens to receive this exemption, at least half of the number of the residents must qualify for a federal income tax credit and the improvements to the residence must be made substantially to accommodate those disabilities (2006 NJ A 3768).

The Price is Right

The Price is Right gives out numerous noncash prizes each show. Along with these prizes, winners are not only responsible for paying the taxes on the item, but also figuring out how to transport the prize from its location to where they live (which could be across

the country). Because of these pitfalls, contestants must ask themselves if the value they receive from the prize is worth all the hassle.

After winning a prize on the Price is Right, you are not required to accept the prize. If you do not want to deal with the hassle of transporting the prize or paying taxes on the prize, you can always decline it. According to a recent contestant, The Price is Right actually hands out papers for winners to fill out if they would like to forfeit their prizes. When she asked why on earth anyone would want to forfeit their prize, she was told that a lot of winners choose to do so. Winners who cannot afford to pay the taxes on these prizes end up forfeiting them (LeClair, 2011).

Oprah's Giveaways

It is well-known that Oprah Winfrey loves to give extravagant gifts to her entire audience. However, what are the audience members responsible for once the show ends? Oprah's representatives have claimed that the show will pay for the tax attributed to such prizes, so that the audience will not be held responsible for any tax owed on the prizes. This does not seem credible, however, since the payment of these taxes for the audience members would be considered an additional gift (which is also taxable), only adding to the tax liability of the recipients.

According to Alan Strauss, who is a New York City tax lawyer and certified public accountant, the giveaways could put audience members into higher tax brackets, which would greatly increase their tax liability for that year. As far as the tax payments paid by Oprah's camp, Strauss says it is Oprah's obligation to withhold tax at a twenty percent tax rate, but the payment of that twenty percent tax by Oprah also becomes a taxable event for the audience (Crudele, 2010). Furthermore, if audience members are above that twenty

percent tax bracket (which is extremely likely after including the value of the prize), they will not only be responsible for repaying that twenty percent but also the extra percentage that is included in their tax bracket.

Trip to Outer Space

In 2005, Brian Emmett made headlines for forfeiting a trip that he won to outer space because he could not afford the income taxes of the prize. Brian entered a sweepstakes by Oracle Corporation, in which he answered a series of online questions on Java computer code. In turn, he won a free trip to outer space, which made him an instant celebrity. He gave countless media interviews and appeared on stage at Oracle's trade show. The prize was a dream come true for Emmett, who had attended space camp and watched shuttle launches from Kennedy Space Center since he was a kid.

Then Emmett realized that he would have to include the prize, worth \$138,000 in his annual income. The related income taxes added up to \$25,000, which would have put the winner into debt. After realizing that he could not afford the taxes on his dream prize, Emmett gave up his seat on the mission and his chance to become the astronaut he had always dreamed about (There are no free rides to outer space, 2007).

Development of Tax Law

Nature of Taxable Prizes

The taxation of prizes has been a hot topic for quite some time. It has been depicted in the media for as long as there has been television. For instance, even the Andy Griffith show had an episode in which Aunt Bea was forced to sell her prizes that she won on a game show in order to pay the taxes that she owed on them. Although the actual tax law

regarding prizes and awards has not changed much over the years, the nature of the prizes that it applies to has.

While large noncash prizes formerly included items like washers and dryers, they can now be as valuable as a new multi-million dollar home (as in the case of *Extreme Makeover: Home Edition*). Cash prizes have also grown exponentially. While cash prizes on prize-awarding shows used to be in the range of thousands of dollars, contestants can now be awarded millions. In fact, the talent show *X Factor* recently broke the record for the largest cash prize in the amount of \$5 million.

Not only have the value of these prizes grown, but the quantity of prizes has also increased drastically. While there used to be a few game shows on television that offered prizes, game shows have become so popular that they now have their own game show network. In addition to game shows offering prizes, there are now reality television shows with that were completely unheard of just a few decades ago.

On top of winning prizes on television shows, almost every American citizen is now able to have the chance of winning big in the lottery. In the United State, lotteries are now offered by forty-three states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. These lotteries may offer prizes from anywhere between a few dollars to multi-million dollar prizes (Lottery Results, 2012). In 1996, the Mega Millions game, which is a large multi-state lottery, was introduced with the participation of six states. As of 2012, the game has expanded to forty-two states plus the District of Columbia and the U.S. Virgin Islands. Gamblers now have the opportunity to win almost \$400 million, which is an amount that was unheard of when lotteries were first created by the states (History of the Game, 2012).

Differences between Countries

While in the United States all prizes and awards (except for certain specific exceptions) are considered as taxable income, other countries treat them much differently. For instance, residents of Canada who receive a gift, inheritance, or receive lottery or other gambling winnings are not taxed on their receipt and do not have to include these amounts as income for tax purposes. In the United Kingdom, prizes won in the lottery are not taxable. National Lottery prizes are not chargeable gains for the purposes of UK Capital Gains Tax and will not normally be assessed for UK Income Tax (Frequently Asked Questions, 2011). Another country that does not tax winners on their prizes is Australia. Australian taxpayers are not required to report prize winnings or proceeds from gambling as income (Preparing Your Tax Return, 2011). While it may make sense to us that prizes are income that we are required to pay taxes on, it seems that the U.S. may be in the minority by including prizes in taxable income.

Advice to Prize Winners

Estimate Tax Liability

If you win a cash prize on a game show or elsewhere, the payment of taxes becomes simpler than if you were to win merchandise. After winning cash, I would advise the winner to meet with a professional accountant right away to estimate what their tax liability will be. They should then immediately set this amount aside from their cash prize so that they do not run short on cash when it comes time to pay their taxes. If I were to win a cash prize, I would wait to make plans for the money until after I had estimated my tax

liability and set aside that amount. I would then decide what to do with the money based on the amount I have left.

Cash v. Noncash Prizes

After contestants have won goods, some game shows may offer a cash option as a substitute for merchandise that a contestant won. This is often a better option for winners because they can then use the cash to pay for the taxes related to the prize. It is an especially attractive option for winners who did not necessarily need the prize that they had won. They are willing to take a cash prize that is less than the value of their original prize so that they can use the money to buy what they need.

The game show *The Price Is Right* often gives out the value of a prize in cash if the prize is not available. While some contestants are disappointed by this because they wanted the prize they won, I don't see the down side to taking cash. You can buy your prize on the market with the cash if it's really what you wanted or you could use the cash for more useful options. You could use a portion to pay off the tax on your prize and use the rest to afford something that you wouldn't otherwise be able to afford.

Accuracy of Fair Value

Winners of noncash prizes should be especially careful when it comes to the evaluation of the prize. Many times, the value on the 1099 that a winner receives is higher than the amount that they could buy the same good for in the marketplace. Winners need to watch out for such over-valuation of their prize. For example, if you are to win a trip from a sweepstakes or game show, make sure to ask a travel agent how much you would have to pay to buy the same trip on your own. Many times the value of the trip includes costs that are not directly related to the winner's individual trip.

If you have proof that the value of your prize has been overstated on your 1099, you should report the actual fair value on your tax return and attach Form 8275 explaining why the amount you reported is different from the amount on your 1099. According to the form's instructions, "Form 8275 is used by taxpayers and tax return preparers to disclose items or positions, except those contrary to a regulation, that are not otherwise adequately disclosed on the tax return to avoid certain penalties." Make sure to retain any proof that you have as to the fairness of your valuation, in case the IRS asks for it.

When filling out Form 8275, it is necessary to describe the prize to which you are referring along with where its value was reported on your 1040 tax return and an explanation of why you are not reporting the value provided on your 1099. For example, if I found out that I could have gone on a trip that I won for much less than the value reported on the 1099 I received, I would fill out Form 8275 describing the trip and its value. I would then explain why I believe my value of the trip is accurate and the value on my 1099 is not. An example of how to fill out Form 8275 in this situation is provided in the appendix on page A1.

Deduction of Expenses

Expenses that are incurred in order to win prizes may be deductible as "miscellaneous itemized deductions" on Schedule A. Such expenses, however, are only deductible if they exceed 2-percent of the taxpayer's adjusted gross income. Miscellaneous itemized deductions include any ordinary and necessary expenses that you pay: to produce or collect income that must be reported as part of your gross income; to manage, conserve, or maintain property held for producing such income; or to determine, contest, pay, or claim a refund of any tax (IRS Publication 529 Miscellaneous Deductions). Since earnings

from prizes and awards must be included as taxable income, expenses incurred in order to earn these prizes should therefore fall into this category of miscellaneous itemized deductions, which are subject to a 2-percent floor.

The current guidance regarding these expenses comes from the tax court memo from 1995 that is based upon the tax court case *Stanley B. and Rose M. Whitten v. Commissioner*. Stanley Whitten was a contestant on the Wheel of Fortune in 1991, on which he won a GEO Tracker and \$14,850 in cash prizes. When reporting his prize on his 1040, Whitten reported the net of these prizes and \$1,820 in expenses incurred (including transportation, meals, and lodging), on line 22 of form 1040. Whitten claimed that he should be able to directly offset his winnings with his expenses because the expenses represent “gambling losses” and his prizes are “gambling winnings” that can be offset by such losses.

The tax court, however, disagreed. Since Whitten is not a professional gambler, nor is in the trade or business of appearing as a contestant on game shows, these expenses are not gambling losses or business expenses. Instead, such expenses may be classified as miscellaneous itemized deductions that may only be deducted subject to the 2-percent floor prescribed by section 67(a) (*Stanley B. and Rose M. Whitten v. Commissioner*, 1995).

Professional Contestant

If a person makes their living by competing on game shows or other contests, they may be considered a professional. In such case, they would be able to deduct all expenses related to these contests as professional fees that are necessary for your course of business, rather than itemizing expenses above the 2-percent floor, as is the case of a non-professional. The tricky part is proving that you are a professional in the business of

appearing as a contestant on game shows and other contests, rather than someone who merely lucks out and makes some money on a show or two.

Very few people would qualify as a professional in this field, but that does not mean that no one could qualify. For example, it could be argued that Boston Rob (who was a contestant on Survivor for multiple seasons and a contestant on Amazing Race) makes his living from competing on television shows, as is therefore a professional competitor. If you make your living by applying for and competing on shows and in contests that give away prizes, I would recommend that you use this to your tax advantage, as long as you can prove that this is your course of business, rather than just a hobby.

Sell the Prize

If you win a prize and do not have a use for it, you could always sell the prize to a third party, but this often comes with extra tax complications. In general, you will not be able to sell the prize for its fair value, which will result in a loss on the sale. A loss resulting from the sale of a capital (or personal-use) asset is never deductible. This is why it is important to not use the prize if you are planning on selling it. If you do not use the item, you may be able to treat it as a capital asset, which means you could deduct a loss if the selling price is lower than the fair value that you paid taxes on (IRS Publication 544 Sales and Other Dispositions of Assets).

If you are considering selling a prize, you should also look closely at your contract with the production company. For example, some contracts restrict you from selling your prize to another party. If you violate this clause in the contestant agreement, you could risk forfeiting the prize altogether. Also, certain prizes cannot be sold because they are

registered in the recipient's name. Such prizes may include hotel stays, airplane transportation, cruises, and gift certificates (Contestants, 2009).

Winning a vehicle comes with even more complications if you are thinking of selling it. You are not able to sell the car legally until you have received it because you must have it registered in your name to sell it. Some contestants may try to sell the car before they receive it so that they can avoid paying license fees, registration fees, or sales tax. This causes even more problems because if the production company finds out that the contestant is trying to circumvent the transaction, the company could suspend delivery of your car or cause you to automatically forfeit the car (Contestants, 2009).

Refuse the Prize

While it may not sound like a very attractive option, you always have the right to refuse a prize that you are offered. Before accepting the prize, consider whether or not you have a use for it, if you can afford the federal and state taxes, and the transportation or whatever other fees may come with the prize. While you could always sell the prize later, you will probably not get its fair value, for which you will be paying taxes on, so you may still be left worse off. If you cannot afford all the associated expenses that come with a prize, it would be much easier to refuse the prize up front rather than having to sell it down the road because it has caused you so much financial grief.

Tax Year

Once you have won a prize, especially on a game show, it is necessary to have patience. Most contestants do not take home their prizes directly from the show's taping. Most shows do not give out the prizes until the show actually airs, which could be months

after the show is taped. After the show airs, it usually has ninety days to send out the prizes (Roberts-Grey, 2011). It is necessary to pay attention to what date you receive your prize because you must report the prize as income in the year that you receive it, not the year that you win it. For example, you may win a car on a game show in 2012 but not have to pay taxes on it until you file your 2013 return if you don't receive the car until 2013.

Conclusion

Because of the excitement that comes with winning a prize, recipients often make poor decisions because they are not thinking logically. Because of the tax consequences that follow a prize, it is important to evaluate how you are going to afford the prize before accepting it. If you are considering applying for a prize or have already won a prize, it is important to speak with your tax professional to ensure that you pay all the necessary taxes associated with the prize. This is very important, because if you do not evaluate your ability to pay the taxes before accepting a prize, you could be forced to forfeit the prize or even worse, as exemplified by the case of Richard Hatch.

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Disclosure Statement

Do not use this form to disclose items or positions that are contrary to Treasury regulations. Instead, use Form 8275-R, Regulation Disclosure Statement.

See separate instructions.

► Attach to your tax return.

OMB No. 1545-0889

Attachment
Sequence No. **92**

Identifying number shown on return

123456789

General Information (see instructions)

(a) Inv. Proc., etc.	(b) Item or Group of Items	(c) Detailed Description of Items	(d) Form or Schedule	(e) Line No.	(f) Amount
	1099-Misc	Trip for 2 to Hawaii. Includes airfare and all-inclusive stay at the Hilton Resort in Honolulu.	1040	21	6,000

Detailed Explanation (see instructions)

g to my research on Priceline.com, I could get airfare and hotel accommodations at the Hilton Resort for only Even if you add in food and travel excursions, the total cost for this trip would not exceed \$3,000.

Information About Pass-Through Entity. To be completed by partners, shareholders, beneficiaries, or residual interest holders.

This part only if you are making adequate disclosure for a pass-through item.

s-through entity is a partnership, S corporation, estate, trust, regulated investment company (RIC), real estate investment (REIT), or real estate mortgage investment conduit (REMIC).

Address, and ZIP code of pass-through entity

2 Identifying number of pass-through entity

3 Tax year of pass-through entity

/ / to / /

4 Internal Revenue Service Center where the pass-through entity filed its return